$817,388.76, determined after deducting current royalties, rents and bonus exhaustion, was a depletable interest acquired by the lessee. But the issue here is, who owned the economic depletable interest in the gas in place which produced the $20,511 of current production allocable to advance royalties? The Supreme Court has held that this interest was reserved by the lessors and that this production depleted the lessors' reserved interest. The Circuit Court of Appeals has erroneously held here that this identical interest was purchased by the lessee and that this production depleted the lessee's interest. This failure of the lower Court to follow the Supreme Court decisions cannot be obscured or glossed over by the loose statement that "after these leases were executed both the lessors and the lessee held depletable economic interests in the property" (R. 98).

The fallacy in the majority opinion below is clearly shown by the following statement (R. 99):

> "It would be plain enough that these payments would have been capital expenditures had they been made for the fee. They were, we think, none the less so because only a leasehold was obtained."

If the petitioner had purchased the fee, the former owner would have made a sale of a capital asset, he would be entitled to no depletion deduction, and he would have no further interest in or relationship to the property. The petitioner would have acquired the entire depletable interest in the property. In cases involving *lessors* this Court has held that the receipt of an advance royalty is essentially different from the receipt of the purchase price for the fee. The Court below, in treating payments for the fee and advance royalties as having the same effect from the standpoint of the *lessee*, simply refuses to follow the Supreme

Court decisions establishing that such transactions are essentially and radically different in nature and consequences.

A particular payment may be income to the recipient and a capital expenditure to the payor, but a transaction which is not a sale by one party cannot be a purchase by the other. A payment which the Supreme Court has held is not the selling price of an interest in the property when received by the lessor cannot be the purchase price of an interest in the property when paid by the lessee. The lessee could not acquire a depletable interest in the property which the lessor kept. And the current production allocable to advance royalties, which the Supreme Court has held was part of the lessor's "gross income from the property" received by him in advance, cannot also be part of the lessee's gross income from the property.

These logical difficulties are not overcome by stating that the advance royalties "were paid as the consideration for the conveyance of a leasehold in which the plaintiff invested to obtain the right to produce gas from the land leased" (R. 99). However the precise rights of the lessee are characterized, the opinion below rests on the premise that in return for the advance royalties the lessee acquired an immediate interest in the gas in place subject to wastage by production. That conclusion cannot be correct, in view of the firmly established principle that the lessors kept and did not dispose of that very interest in the gas in place.

The only conclusion which is consistent with the principles established by the Supreme Court is that the advance royalties were payments "in advance for oil and gas to be extracted" (*Herring* v. *Commissioner*, 293 U. S. 322, 324 [1934]) and were, as the Court below itself said, payments for "the right to obtain a series of transfers of the oil as produced" (R. 98).

As said in the dissenting opinion below,

> "such a 'bonus' is payment in advance for units of gas, in which, although the lessee has the right to withdraw them in the future, the lease gives him no immediate interest. Conversely, the lessor does not part with any interest in the gas until the lessee withdraws it" (R. 100).

The reasoning of the Court in *Sunray Oil Company* v. *Commissioner*, 147 F. (2d) 962 (C. C. A. 10th, 1945), cert. den. 65 S. Ct. 1201, is the same as that of the decision below. That Court also erroneously held as to advance royalties that "with respect to the lessee, they represent cost and are a capital expenditure" (p. 966) and that the portion of the advance royalties allocable to current production "were in no sense the proceeds of oil reserved by the lessors as royalty under the lease" (p. 966).

We submit that the character of the transaction and the rights created by oil and gas leases providing for advance royalties are definitely settled by the Supreme Court decisions in the lessor cases. The petitioner "merely asks that the lease shall be construed in the same way, when the lessee is taxed" and says "that the rights created cannot vary as one looks through different ends of the same document" (R. 100, 101).

We respectfully submit that the decision below should be reviewed by this Court because, in holding that by making payment of advance royalties the lessee acquired from the lessors a depletable interest in the gas in place, the lower Court rendered a decision in direct conflict with the decisions of the Supreme Court that this depletable interest in the property was retained by the lessors. The question involved has not been directly decided by this Court. The question is one of great importance to the oil and gas industry and in the administration of the Internal Revenue Laws. The writ of certiorari on this point should be granted.

II.

In the alternative, the Circuit Court of Appeals erred in denying petitioner the percentage depletion deduction on that portion of its gross income from the property allocable to such advance royalties. A regulation denying a taxpayer percentage depletion on part of its gross income from the property is contrary to the statute and invalid.

Petitioner's alternative argument is that if the amount representing current production allocable to advance royalties is gross income of the petitioner-lessee, as the lower Court has held, it necessarily follows under Section 114(b)(3), Revenue Acts of 1934 and 1936, (Appendix p. 25) that the petitioner is entitled to the percentage depletion deduction with respect to this income.

The Circuit Court of Appeals summarily rejected this contention merely by stating that a valid regulation (Article 23(m)-1, Regulations 86 and 94, Appendix p. 26) denied this deduction (R. 99-100).

The statute, Section 114(b)(3), Revenue Acts of 1934 and 1936, (Appendix p. 25) allows as to oil and gas wells, as an alternative to the ordinary depletion allowance based on cost under Section 23(m),

> "27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property."

As to any particular taxpayer, the term "gross income from the property" as used in this section means gross income from oil and gas (*Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312 [1934]) of the particular taxpayer whose

depletion deduction is being computed (*Crews* v. *Commissioner*, 89 F. (2d) 412 [C. C. A., 10th, 1937]; *Commissioner* v. *Felix Oil Co.*, 144 F. (2d) 276 [C. C. A., 9th, 1944]; *Commissioner* v. *Crawford*, 148 F. (2d) 776 [C. C. A., 9th, 1945], affirmed ..... U. S. ..... (January 28, 1946). The statutory plan is that each person having an interest in the oil and gas property which is depleted by production should account for his share of the gross income from the property and should be entitled to the depletion deduction with respect thereto (*Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312 [1934], *Kirby Petroleum Company* v. *Commissioner* ..... U. S. ..... (January 28, 1946).

The Court below has held that the current production allocable to advance royalties is gross income of the lessee. This amount is obviously "gross income from the property." Section 114(b)(3) in plain terms allows the lessee the 27½% depletion deduction with respect to this portion of its gross income from the property.

The specific provision of the statute for the exclusion of "an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property" has no application because of the holding of the Circuit Court of Appeals that "advance royalties" are not "rents or royalties" but are capital expenditures, the purchase price of an economic interest in the property. Capital expenditures returnable through depletion cannot be "rents or royalties".

The regulation, Article 23(m)-1(g) (Appendix, p. 26) applies only "if *royalties* in the form of bonus payments or advanced royalties * * * have been paid." Literally the regulation is not applicable to lease bonuses or advance royalties which are held to be capital expenditures.

If the regulation is construed as applicable to advance royalties which are capital expenditures it is invalid.

A regulation denying the taxpayer a deduction which the statute clearly allows is invalid (*Trust u/w of Mary Lily Flagler Bingham* v. *Commissioner*, 65 S. Ct. 1232 [1945]; *Koshland* v. *Helvering*, 298 U. S. 441, 446-447 [1936]; *Manhattan General Equipment Co.* v. *Commissioner*, 297 U. S. 129, 134 [1936]).

The regulation denying the lessee the percentage depletion deduction with respect to current production allocable to advance royalties was undoubtedly based on the ground that this share of the gross income from the property belonged to the lessor, that the lessor was being allowed the percentage depletion deduction with respect thereto, and that the percentage depletion deductions allowed in the aggregate to all taxpayers having depletable interests in the property should not be more than 27½% of the total gross income from the property (*Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312 [1934], *Kirby Petroleum Company* v. *Commissioner*, ... U. S. ..... (January 28, 1946). But the regulation is inapplicable or invalid as applied to current production allocable to a capital expenditure by the lessee for an economic interest in the gas in place.

The statute is perfectly clear. Each taxpayer having an investment in a depletable interest in the property is entitled to the percentage depletion deduction with respect to his share of the gross income from the property, a reasonable and equitable result. The lower Court holds that $20,511 of the 1934 gross income from the property allocable to advance royalties is the lessee's gross income from its depletable interest in the property. The statutory provision for the exclusion of "rents and royalties" is inapplicable. The lessee is therefore entitled to percentage depletion with respect to this share of its gross income from the property by the plain terms of the statute and the Commissioner has no power by regulation to deny a deduction which the statute plainly allows.

In holding that the lessee could claim depletion based upon cost on production from the depletable interest purchased with the advance royalties, but could not claim percentage depletion with respect thereto, the lower Court ignored the fact that every taxpayer who is entitled to a depletion deduction with respect to a depletable interest in an oil or gas property is entitled to compute depletion on the percentage of gross income basis if that produces a greater allowance than that granted by Section 23(m). Cost depletion and percentage depletion are alternative deductions of the same nature allowable to the same person with respect to the same production from the same economic interest. If a taxpayer is entitled to cost depletion with respect to certain production, he is undoubtedly entitled to percentage depletion, if that is greater, with respect to the same production (*Kirby Petroleum Company* v. *Commissioner*, ... U. S. ..... (January 28, 1946); *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459 [1933]; *Herring* v. *Commissioner*, 293 U. S. 322 [1934]; *Thomas* v. *Perkins*, 301 U. S. 655 [1937]; *Consumers Natural Gas Co.* v. *Commissioner*, 78 F. (2d) 161 [C. C. A., 2d, 1936]; *Champlin* v. *Commissioner*, 78 F. (2d) 905 [C. C. A., 10th]; *F. K. Land Co.* v. *Commissioner*, 90 F. 2(d) 484 [C. C. A., 9th, 1937]; *Commissioner* v. *I. A. O'Shaughnessy, Inc.*, 124 F. (2d) 33 [C. C. A., 10th, 1941]).

On the first point the lower Court holds that by paying advance royalties the lessee acquired an immediate depletable interest in the gas in place. In denying the lessee depletion on the production from this interest, the Court inconsistently treats the lessee as not having acquired this depletable interest. For one purpose this gas is regarded as purchased in place and not as produced, but for the other as purchased upon production from another's depletable interest.

This point high lights the error of the lower Court in holding that the portion of the current gross income from the property allocable to advance royalties was gross income of the lessee. If that erroneous holding is to be adhered to, it is logically impossible to avoid the conclusion that the lessee is entitled under the plain language of Section 114(b)(3) to the percentage depletion deduction with respect to this share of its gross income from the property.

This alternative point is likewise of great importance to the oil and gas industry and in the administration of the Internal Revenue Laws. The question has never been decided by this Court and was not involved in the petition for certiorari in *Sunray Oil Co.* v. *Commissioner*, 65 S. Ct. 1201 (1945). The two questions raised in this petition are interdependent and have been inconsistently decided below. The writ of certiorari on this point should also be granted.

Conclusion.

For the foregoing reasons it is respectfully submitted that the petition for writ of certiorari to the Circuit Court of Appeals for the Second Circuit should be granted.

Respectfully submitted,

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Appendix.

Section 22(a), Revenue Acts of 1934 and 1936:

"Sec. 22. GROSS INCOME.

"(a) GENERAL DEFINITION.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

Section 23(m), Revenue Acts of 1934 and 1936:

"Sec. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

* * * * * *

"(m) DEPLETION.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between

the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).)"

Section 114(b), Revenue Acts of 1934 and 1936:

"Sec. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * * *

"(b) BASIS FOR DEPLETION.—

"(1) GENERAL RULE.—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in subsections (2), (3) and (4) of this subsection.

* * * * * *

"(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph."

Article 22(a)-5 of Regulations 86 and 94:

"Art. 22(a)-5. *Gross income from business.*—In the case of a manufacturing, merchandising, or mining business 'gross income' means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold. But see article 23(m)-1(g)."

Article 23(m)-1(g) of Regulations 86 and 94:

"Art. 23(m)-1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—

* * * * * *

"(g) * * * In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the 'gross income from the property.' If royalties in the form of bonus payments or advanced royalties (see article 23(m)-10) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from 'gross income from the property' for the taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the products sold during the taxable year."

Article 23(m)-10 of Regulations 86 and 94:

"Art. 23(m)-10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) If a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the basis for depletion as provided in section 114(b)(1)

or (2) which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the lessor's basis for depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

* * * * * *

"(d) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ per cent of the amount thereof; * * *."